VZCZCXRO8073
RR RUEHDBU RUEHLN RUEHVK RUEHYG
DE RUEHYE #1105/01 2231259
ZNR UUUUU ZZH
R 111259Z AUG 06
FM AMEMBASSY YEREVAN
TO RUEHC/SECSTATE WASHDC 3713
INFO RUCNCIS/CIS COLLECTIVE
RUEHAK/AMEMBASSY ANKARA 1098
RUEHIT/AMCONSUL ISTANBUL 0494
RUEATRS/DEPT OF TREASURY WASHDC 0428
RUCPDOC/DEPT OF COMMERCE WASHDC

UNCLAS SECTION 01 OF 03 YEREVAN 001105

SIPDIS

SENSITIVE
SIPDIS

DEPT FOR EUR/ACE AND EUR/CARC

E.O. 12958: N/A
TAGS: ECON EFIN EAID AM
SUBJECT: REMITTANCES: ARMENIA'S SECOND-HAND DUTCH DISEASE?

REF: 05 YEREVAN 1627

Sensitive but unclassified. Please protect accordingly.

SUMMARY

¶1. (U) Local media are abuzz with conspiracy theories regarding the sharp appreciation of Armenia's currency, the Dram. The Dram exchange rate is up nearly 30 percent against the dollar since 2003, 7 percent in the first six months of 2006 alone. We believe the Armenian Central Bank (CBA)--as does the resident IMF representative--when it says that the appreciation is simply a matter of market forces. In fact, with a freely (and transparently) floating exchange rate, the kind of manipulation the critics allege is probably beyond the GOAM's power. The most persuasive explanation of the strengthening Dram is the steady rise in the volume of remittances from Armenian labor migrants working in the booming Russian economy. END SUMMARY.

THE UNSTOPPABLE DRAM

¶2. (U) The Armenian dram hit a new high against the dollar this week reaching 399 dram to the dollar on Friday. The dram has appreciated almost 30 percent against the dollar since 2003 and the trend has continued dramatically over the course of the summer, from a rate of 446 dram to the dollar on May 1 to 399 to the dollar on August 10, a more than ten percent decline. As a point of comparison, the Euro declined by 7 percent and the Ruble by 8 percent during the same time period.

REMITTANCES: SECOND-HAND "DUTCH DISEASE"?

¶3. (U) The Chairman of the Central Bank of Armenia (CBA) Tigran Sargsyan insists, with strong support from the IMF, that dram appreciation is the result of increased remittances, the general decline of the dollar and other market forces. Indeed, the IMF, CBA and our own USAID experts agree that increased remittances, particularly from Russia where many Armenian seasonal workers are employed in the booming oil and mining sectors, are the primary driver of dram appreciation.

¶4. (U) A CBA study on remittances (septel) finds that there has been a significant increase in foreign currency inflows

to Armenia, which reached USD 940 million in 2005 and are projected to reach USD 1.1 billion in 2006, accounting for approximately twenty-five (25) percent of GDP. Net inflows sent by physical persons through the banking system have increased from an average of USD 119 million annually for 2001-2003 to USD 350 million in 2005. CBA Board Member Vache Gabrielyan suggested that Armenia's reliance on remittances may even be a form of "second-hand Dutch disease," damaging the economy generally and leaving Armenia excessively vulnerable to external shocks. (NOTE: "Dutch Disease" is an economic phenomenon typically seen in petroleum exporting countries. Dutch disease occurs when exports of lucrative primary-resource products bring home more capital inflows than the poorly developed/undiversifed economy can easily handle. The resulting currency appreciation then drives local manufacturers out of business, as exports are uncompetitve and local consumers/companies find it cheaper to buy foreign goods. END NOTE.)

PRESS CRIES CORRUPTION

¶5. (U) The press has harshly criticized the CBA for the dramatic appreciation, claiming that the Bank's chairman is manipulating the currency for the benefit Armenia's wealthiest importers. Some parliamentarians have also cried foul. The Bank refutes such claims, pointing out that most Armenian oligarchs are both importers and exporters and so are both helped and hurt by the situation. The dram has been freely traded on the Armenian stock exchange since November 15, 2005. Indeed, since August 1, the CBA has bought USD 20 million on the stock exchange in an unsuccessful effort to slow the pace of the dram's appreciation.

FEW OPTIONS FOR THE CENTRAL BANK

¶6. (SBU) Central Bank Board Member Vache Gabrielyan told us that the CBA has very few options in this situation. If the Bank fixes the exchange rate, the result will likely be a sharp increase in inflation which would be politically untenable. Another option would be to allow the inflation rate cap to increase from the current 3 percent to 10 percent. The Bank is reluctant to do so, however, out of concern that it would erode the already low levels of trust in the dram, hurt the poor and bring Armenia out of compliance with its IMF Poverty Reduction Strategy. Theoretically, the Ministry of Finance could take fiscal measures which could help the situation, but Gabrielyan told us "there is neither the desire nor the competence" within the Ministry of Finance for an appropriate fiscal response. Gabrielyan said that the Bank plans to continue with its current policy of intervening in currency markets to smooth out volatility, not to change trends.

A GLOBAL PROBLEM?

¶7. (SBU) According to IMF Resident Representative Jimmy McHugh, local currencies have been appreciating against the dollar at a similar rate throughout the region. McHugh claims that the U.S. economy is partially responsible for this problem because so many dollars have been injected into the world market over the past few years. McHugh speculated that this excess of dollars on the world market could lead to a loss of confidence in the dollar which could have devastating affects in Armenia and throughout the region.

LOCAL EXPORTERS THREATEN TO LEAVE

¶8. (U) On June 15, Hrant Vardanyan, one of Armenia's largest manufacturers of tobacco and confectionery items, threatened to move his production operations to Georgia and Russia because of problems exporting in the face of such a strong dram. Vardanyan's two tobacco companies employ more than 1000 people and buy raw tobacco from hundreds of Armenian farmers, and such a move could seriously damage the Armenian economy. Other exporters have echoed Vardanyan's complaints, but critics claim that these exporters lack the competitiveness to survive outside the Armenian market.

DRAM USE INCREASES

¶9. (U) While there has been considerable public grumbling about the situation, the increase in the overall volume of remittance has left purchasing power little diminished and many Armenians and employers are responding to the situation by increasing their reliance on drams. Even the Embassy recently decided to set local staff salaries in drams. According to the IMF the narrow (or M1) money supply (essentially local currency) increased by 52 percent in 2005 with minimal inflation because Armenians are converting their dollar holdings into drams. (NOTE: In June 2005, Armenia's new currency law came into effect which requires that local goods and salaries be priced in drams (reftel). END NOTE.)

"THE POOR AIN'T SO BAD"

¶10. (U) Despite flak from the press and politicians, who proclaim that the dram appreciation is hurting Armenia's poorest citizens, in fact there is little evidence of this. The argument is that Armenia's poor are disproportionately sustained by dollar remittances from their families abroad, and their purchasing power has taken a sharp hit in recent months. Genuine popular outcry has been fairly muted, however. Further, Gabrielyan pointed out that the very factor driving the dram appreciation (increased remittances from abroad) mitigates its effect on remittance-dependent families. In other words, though an Armenian household is able to buy less with each dollar sent from abroad, most are receiving more dollars than before. Thus, their total

purchasing power remains roughly the same. Alternatively, perhaps more remittances are being sent in the form of rubles, which has also appreciated against the dollar, which would be another easy mechanism insulating Armenian households from the ill-effects of dollar depreciation. Large organizations who happen to have dollar-denominated contracts would, of course, be less lucky.

--- --------
COMMENT: RELIANCE ON REMITTANCES: THE LONG-TERM RISK
--- --------

¶11. (U) Armenia's recent years of double-digit economic growth have been built in significant part on rising capital inflows: remittances, foreign aid and foreign direct investment. These net inflows will likely drive the dram even higher in the coming years. Exporters, who suffer from this trend, will be forced to become more competitive to remain in the market--or to fail. The risk of a "Dutch disease" hollowing-out of the domestic economy is real, especially so long as the Russian economy provides such comparatively lucrative labor opportunities to droves of Armenian workers. Conversely, the Armenian economy is also quite vulnerable should these sources of foreign capital quickly dry up.
EVANS